PUBLIC HEARING

BILL 15-243, "CORPORATE INCOME TAX BASE PROTECTION ACT OF 2003"

Before the
Committee on Finance and Revenue
Council of the District of Columbia

The Honorable Jack Evans, Chairman

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Room 412

Testimony of
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Good morning, Chairman Evans, and members of the Committee on Finance and Revenue. I am Daniel Black, director of operations for the Office of Tax and Revenue (OTR). With me today is Mary Harcar, general counsel for OTR. We are pleased to appear before you this morning to comment on Bill 15-243, the "Corporate Income Tax Base Protection Act of 2003."

Bill 15-243 seeks to close a loophole in local tax law that permits corporate entities to reduce their net taxable income and, thus, avoid paying a significant amount of franchise tax to the District. The bill would: (1) disallow deductions for certain payments to related corporate holding companies that are not taxable in the District; and (2) change the definition of "business income" to conform automatically to U.S. Supreme Court rulings.

The first section of the bill addresses a corporate tax reduction method used by companies in the District and other jurisdictions across the country. Under this tax shelter scenario, corporations make payments to related holding companies located outside the state for the use of patents, copyrights, trade names and other intangible property. The holding companies are typically organized in Delaware or other states that do not tax intangible assets, and their incomes are not apportioned to the states in which the operating companies conduct business. Bill 15-243 would require District franchise taxpayers to add those amounts paid to holding companies back to the taxpayers' net income.

OTR has been reviewing the impact of these Delaware Passive Investment Companies (PICs) on the collection of the corporate franchise tax in the District.

However, the deductions are not easily identified because they are often embedded in other deductions on the tax return. The bill would require companies to disclose payments to related passive investment companies and to pay tax on those amounts that had been deducted from gross income. To the extent that companies comply with this requirement, revenue will increase. More than likely, some companies will not comply voluntarily, and it will be necessary to use enforcement resources to achieve compliance. Needless to say, OTR's enforcement resources are in short supply.

While some jurisdictions have used the strategy of requiring the "addback" or a similar disallowance provision, such as that proposed in Bill 15-243, other jurisdictions have relied upon litigation to address these issues. The latter method was employed by the state of Maryland. Just last week, Maryland's highest court declared a Delaware PIC subsidiary used in *Maryland v SYL Inc* (6/9/2003) as having no real economic substance as a separate business entity and declared the subject transaction a "sham." The Court of Appeals of Maryland held that the Delaware entity had nexus with Maryland and "an appropriate portion of the royalty income of the Delaware PIC was subject to corporate income tax by Maryland." However, the litigation method is time- and resource-intensive (the Maryland case was seven years in the making) and offers no guarantee of success. In addition, promoters of tax shelters have been able to effectively argue that case law and corrective legislation are not applicable to a particular shelter.

Another option would require corporations to file a "combined report" tax return to eliminate the Delaware PIC benefit. Sixteen states currently have this requirement in their tax codes. This method also generally eliminates all intra-corporate payments.

OTR would support any effort by the Council and Mayor to provide an effective tool against devices such as the Delaware PIC. We are currently considering a number of tax reform vehicles to protect revenue and to ensure that appropriate taxes are paid by the corporate tax sector of the business community. We know, for instance, that approximately 65 percent of corporations that filed in the District for the 2001 tax year paid the $100 minimum tax under §47-1807.02(b).

Finally, OTR suggests the legislation be amended for clarity, in both the long title and the text of the bill. We make the following technical recommendations:

- Section 47-1803.03(d) should be amended to add the following phrase to make clear that these deductions to Delaware PIC-type entities are not allowable: "disallow all deductions of payments to a related corporation located outside the District."
- In the "long title," Line 21, replace the term "include in" with the term "add back to,"
- In Sec. 2(a), line 34, expand the bill language to include "rentals, leases, or other arrangements for costs or expenses paid or accrued for patents, copyrights or royalties."
- In Sec. 2(a), in the reference to and use of the term "related members" in Line 8 of page 2 of the Bill, there should be a definition that references the term "affiliated member" as defined in the Internal Revenue Code or the Treasury regulations issued thereunder.

Thank you, Mr. Chairman, for this opportunity to testify. We are available for any questions you may have.

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